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SUBJECT: MEDVEDEV AND THE "GOLDEN MEAN"

Classified By: Ambassador John Beyrle, Reasons 1.4 (b/d).

Summary

11. (C) In a May 25 speech on budget priorities, the first-ever to the Cabinet, President Medvedev acknowledged that the economic downturn was far from over. Medvedev also appeared to side with economic conservatives, who favor sharp reductions in government spending, in the televised May 25 speech by offering a grim economic prognosis for the remainder of the year. Medvedev underscored that social obligations remained the country's highest priority but that public spending had to be kept within reasonable limits; Russia needed to find the "golden mean." The country faced an imperative to uphold the economy and to support those in need, but should not and could not fulfill every short-term need at the expense of long-term goals. Describing the budget as a "key tool" for achieving Russia's long-term modernization objectives, Medvedev sketched a 10-point plan for the budget that ranged from reducing the budget deficit to optimizing support for the real economy, to increasing the quality of government services, to improving support for the disabled.

12. (C) In a meeting the next day with business leaders, Medvedev nevertheless said the government would continue to aid struggling industries and cautioned against undue pessimism. He also scolded the country's leading economic conservative, Finance Minister Aleksey Kudrin, for recent remarks that the downturn may last "40 to 50 years." For his part, Kudrin claimed that he was referring to the recent period of windfall oil and gas revenues, which he said might not return for a long time. In that regard, Kudrin suggested that the oil price assumption for the 2010 budget would be \$50 per barrel, producing a deficit of 5 percent of GDP. Our contacts characterized Medvedev's plan as ambitious, but were doubtful improvements in planning and implementation would be forthcoming in the medium term. End Summary.

Medvedev's First Budget Address

13. (SBU) In a televised speech on May 25, President Medvedev addressed the Cabinet on the government's budget priorities over the three-year budget cycle, through 2012. This was the first time the Russian president had personally delivered a budget address, normally the domain of the Prime Minister. In the past, both Presidents Yeltsin and Putin had been content to submit a written budget address to the Duma and

Federation Council. Moreover, the Kremlin chose to raise the profile of the address by broadcasting it live.

14. (SBU) Medvedev's did not mince words about the state of the economy calling it a difficult situation and acknowledging that the global economic crisis was far from over. He presented no new information or outlook on the economy but instead explained matter-of-factly that the economy was contracting more sharply than expected and that it had already resulted in lower revenue for this year's federal budget, which would be in deficit for the first time in a decade. This year's and next year's expected deficit notwithstanding, Medvedev said that past years of fiscal conservatism had produced a substantial accumulation of reserves, which would allow the government to increase funding for social obligations such as pensions, unemployment benefits and support to the regions despite the crisis.

15. (C) Medvedev's pessimistic comments about the economy echoed those of his principal economic advisors, Presidential Assistant Arkadiy Dvorkovich and Kudrin, and were interpreted locally as evidence that the views of fiscal conservatives such as Kudrin had won the internal GOR argument over the severity of the downturn and the need for spending restraint. More optimistic voices, including Putin and First Deputy Prime Minister Igor Shuvalov have argued that the economy would begin to recover by the third quarter of 2009 and as a result have been loath to cut spending in response to the crisis, arguing that Russia's substantial reserves would allow the country to continue its current policies. (N.B. As if on cue in support of the fiscal conservatives, Deputy Economics Minister Andrey Klepach, the government's chief

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macroeconomist, said May 26 that GDP in April had declined 10.5 percent, an even steeper fall than the 9.5 percent in the first quarter of 2009.)

A 10-Point Plan

16. (SBU) In his speech, Medvedev maintained that the GOR had an obligation to adopt conservative fiscal assumptions, including on oil prices, to ensure that expenditures did not become a source of macroeconomic instability; spending had to be kept within reasonable limits. At the same time he expressed support for spending to alleviate and prevent poverty and to stimulate demand. Russia must find the "golden mean." He also admonished Cabinet members not to focus on urgent short-term needs at the expense of the country's longer-term need to modernize and reduce dependence on commodity exports. The budget should facilitate an expansion of commerce and encourage the development of new technologies for new entrepreneurs and established companies alike.

17. (SBU) Characterizing the budget one of the "key tools" for achieving the country's long-term goals, Medvedev called for an adaptive budget policy that could identify which programs were effective and which programs the GOR should discontinue. He sketched the following 10 themes in his written address the GOR should follow in its planning for the 2010 federal budget:

- Fulfill social spending commitments, make them more targeted; increase authority of local officials in decision making;
- Reduce the budget deficit; plans to set aside more revenue as reserves increases decision making flexibility;
- Introduce cost-cutting measures; prioritize programs that have the greatest social multiplier effect and decrease or eliminate programs that do not merit the "spending of taxpayers' money";
- Optimize support for the manufacturing and industrial sectors by promoting energy efficiency, labor productivity,

and technological modernization;
--Improve the quality of public services, which may mean allowing the private sector to perform them;
--Improve the efficiency and transparency of the public procurement system;
--Establish an economically justified tax burden that encourages greater commercial activity, better energy efficiency as well as more research and development;
--Hold authorities at every level of government accountable for effective budget spending;
--Build a reliable and balanced pension system;
--Create a barrier-free environment for people with disabilities.

After the Speech

¶8. (SBU) Following a meeting with a group of businessmen on May 26, Medvedev said Russia was in better shape than most other countries and had the resources and the right ideas to address the crisis. He warned against excessive pessimism and, in a thinly veiled shot at Kudrin, said it was unacceptable for government officials to say that Russia would not emerge from the crisis for 40-50 years.

¶9. (SBU) Medvedev also provided additional clarification on his budget priorities, noting that changes in taxation would probably not include a reduction of value-added taxes (VAT) because a rate cut was not a guarantee of increased collection. Nevertheless, he said excise taxes on tobacco and alcohol would increase. Medvedev also suggested cuts were in store for state corporations such as Rosnano and the Housing Reform Fund but that the government would continue to support ailing industries such as agriculture and automobiles (both important sources of employment). Medvedev also reiterated his calls for a more diversified economy and urged businesses to profit from the downturn by becoming more efficient.

¶10. (SBU) For his part, Putin told a conference of trade union chairmen that budget funding for natural resources

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firms and state monopolies would continue as a means of supporting the organizations' investment programs. The 2010 budget would also reduce the number of exemptions available to offshore entities. Putin also pledged that no further action would be taken to close Russia's markets off from metallurgical and automobile imports.

¶11. (SBU) In response to Medvedev's criticism, Kudrin said he had been referring to the likelihood of a return to windfall revenues from oil and gas, which might not occur for 40 to 50 years. Despite the admonition from Medvedev, he continued to be bearish in public. Kudrin stated that the preliminary oil price assumption for the 2010 budget would be \$50 per barrel (Urals blend is currently trading near \$60 a barrel) in keeping with Medvedev's call for conservative commodity price forecasts. Kudrin also estimated that the 7.4-percent of GDP deficit in 2009 and the 5-percent of GDP deficit in 2010 would exhaust the Reserve Fund's remaining \$106 billion and that the GOR would likely borrow on international credit markets, but would not approach the IMF, as a means of conserving Reserve Fund resources. He anticipated borrowing \$7 billion this year and approximately \$10 billion during 2010.

Observers Skeptical

¶12. (C) Merrill Lynch Chief Economist Yulia Tspeliaeva told us Medvedev's plan was ambitious and similar to his pre-election rhetoric. She credited Medvedev for the effort to draw the public's attention to the GOR's 2010 budget

planning efforts and was hopeful that the dire economic situation would prompt budget management improvements. However, Tsepliaeva was doubtful the state would reduce its interference in the economy or that the entrenched system of official corruption would yield to Medvedev's attempt at reform.

¶13. (C) In his May 26 note, Deutsche Bank Chief Economist Yaroslav Lissovolik speculated that the relative urgency of supporting social obligations would probably crowd out Medvedev's interest in working toward longer-term goals and in reducing government spending. He said policy makers would focus on increasing household consumption in the short to medium term by maintaining a strong ruble, to the detriment of the country's industrial competitiveness and that important infrastructure and modernization needs would get short shrift in near-term budgets.

Comment

¶14. (C) Despite the criticism of Kudrin, it is clear to us as well as to most local observers that Medvedev's budget address reflected the influence of fiscal conservatives -- especially Kudrin, who has been by far the most outspokenly pessimistic among senior officials. That said, perhaps the most telling aspect of the address in that regard was Medvedev's call for Russia to find the "golden mean." Inside the GOR, policy battles are never won, and the tendency is always for the various clans to compromise and temporize. We fully expect that the current and 2010 budget will undergo still more revisions to accommodate an economic situation that has farther to fall. A key question is the effect of that contraction on the interests of Russia's economic and governing elite, but we still think the reformers (like Kudrin) maintain a stronger position versus statist/protectionist forces, for now. End Comment.
BEYRLE